1. FINANCIAL STATEMENT PRESENTATION

A. *Introduction*

The accompanying combined financial statements (Statutory Basis Financial Report) of the Commonwealth of Massachusetts (the Commonwealth) are presented in accordance with the requirements of Section 12 of Chapter 7A as amended by Section 4 of Chapter 88 of the Acts of 1997 of the Massachusetts General Laws. The Office of the Comptroller also publishes the Commonwealth's Comprehensive Annual Financial Report (CAFR) which is prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for governments. GAAP is prescribed by the Governmental Accounting Standards Board (GASB), the authoritative standard-setting body for establishing governmental accounting and financial reporting principles.

The Statutory Basis Financial Report (SBFR) includes all the budgeted and non-budgeted funds and account groups of the Commonwealth, as recorded by the Office of the Comptroller in compliance with Massachusetts General Laws and in accordance with the Commonwealth's budgetary principles.

The Statutory Basis Financial Report's General Purpose Financial Statements are not intended to include independent authorities, non-appropriated funds of higher education or other organizations included in the Commonwealth's reporting entity as it would be defined under GAAP.

B. *Statutory Basis*

The Commonwealth reports its statutory basis financial position and results of operations in funds and account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

Account groups are accounting entities used to provide accountability for the Commonwealth's general fixed assets and long-term obligations. They are not considered funds because they do not report expendable available financial resources and related liabilities.

C. *Governmental Fund Types*

The Fund types and account groups are organized as follows:

Governmental Fund Types account for the general governmental activities of the Commonwealth.

Budgeted Funds – are the primary operating funds of the Commonwealth. They account for all budgeted governmental transactions. Major budgeted funds include the General, Highway and Local Aid funds which are identified by the Comptroller as the operating funds of the Commonwealth.

Non-Budgeted Special Revenue Funds – are established by law to account for specific revenue sources that have been segregated from the budgeted funds to support specific governmental activities such as federal grants, funds related to the tobacco settlement and the operations of the state lottery.

Capital Projects Funds – account for financial resources used to acquire or construct major capital assets and to finance local capital projects. These resources are derived from proceeds of bonds and other obligations, which are generally received after related expenditures have incurred, operating transfers authorized by the Legislature and from federal reimbursements. Deficit balances in Capital Projects Funds represent amounts to be financed.

D. *Fiduciary Fund Types*

Fiduciary Funds account for assets held by the Commonwealth in a trustee capacity (Trust Funds), or as an agent (Agency Funds) for individuals, private organizations, other governmental units, and/or other funds.

Expendable Trust Funds – account for trusts whose principal and investment income may be expended for a designated purpose.

Nonexpendable Trust Funds – account for trusts whose principal cannot be spent.

Pension Trust Funds – account for the net assets available for plan benefits held in trust for the State Employees' and Teachers' Retirement Systems.

Agency Funds – account for assets the Commonwealth holds on behalf of others. Agency Funds are custodial in nature and do not involve measurement of operations.

E. *Account Groups*

Account Groups establish control and accountability over the Commonwealth's general fixed assets and long-term obligations.

General Fixed Assets Account Group – accounts for the general fixed assets of the Commonwealth and capital leases.

General Long-term Obligations Account Group – accounts for long-term bonds and notes issued by the Commonwealth and capital leases.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. *Statutory Basis of Accounting*

The Statutory Basis Financial Report is prepared from the Commonwealth's books and records and other official reports which are maintained on the basis of accounting used in the preparation of the Commonwealth's legally adopted annual budget (statutory basis). The statutory basis emphasizes accountability and budgetary control of appropriations. The Statutory Basis Financial Report is not intended to present the Commonwealth's financial condition and results of operations in conformity with GAAP. Under GAAP, the books are accounted for using a current financial resources measurement focus and the modified accrual basis of accounting.

Under the statutory basis of accounting, revenues are generally recognized when cash deposits are received by the Treasury. However, revenues receivable for federal grants and reimbursements are recognized when related expenditures are incurred. Amounts due from political subdivisions of the Commonwealth are recognized when considered measurable and available. Deeds excise taxes are recognized at the time of collection by the counties and the Commonwealth.

Under the statutory basis of accounting, expenditures are generally recorded when the related cash disbursement occurs. At year-end, payroll is accrued and payables are recognized, to the extent of approved encumbrances, for goods or services received by June 30. Costs incurred under the federally-sponsored Medicaid program, amounts required to settle claims and judgments against the Commonwealth, and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment. Under GAAP, expenditures are recorded in the period in which the related fund liability is incurred.

The Pension Trust Funds are reported using a flow of economic resources measurement focus and the accrual basis of accounting on both the statutory and GAAP basis. Under this method, additions are recorded when earned and deductions are recorded at the time liabilities are incurred. This measurement focus emphasizes the determination of net change in assets available for pension benefits.

The accounting policies followed in preparing the accompanying statutory basis financial report are described in the remainder of this section.

B. ***Cash, Short-term Investments and Investments***

The Commonwealth follows the practice of pooling the cash and cash equivalents of its Governmental and Fiduciary Funds. Cash equivalents consist of short-term investments with an original maturity of three months or less and are stated at cost. Interest earned on pooled cash is allocated to the General Fund, Expendable Trust Funds and, when so directed by law, to certain Special Revenue and Capital Projects Funds.

The Commonwealth enters into interest rate swap agreements to modify interest rates on outstanding debt. Other than the net interest expenditures resulting from these agreements no amounts are recorded in the financial statements.

The Pension Trust Funds, with investments of approximately $26,994,602,000 at fair value, are permitted to make investments in equity securities, fixed income securities, real estate, timber and other alternative investments. For investments traded in an active market, the fair value of the investment will be its market price. The Pension Trust Funds include investments in real estate, venture capital funds, real estate funds, limited partnerships, futures pools, international hedge pools, commodities pools, balanced pools, leveraged buyouts, private placements and other alternative investments. The structure, risk profile, return potential and marketability differ from traditional equity and fixed income investments. Concentration of credit risk exists if a number of companies in which the fund has invested are engaged in similar activities and have similar economic characteristics that could cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. To mitigate the exposure to concentrations of risk, the Pension Trust Funds invest in a variety of industries located in diverse geographic areas. As of June 30, 2003, the estimated fair values, determined by management with input from the investment managers, of these real estate and alternative investments were $4,093,922,000 of the Pension Trust Funds, representing 8.0% of the total assets of the Fiduciary Fund Type.

C. ***Securities Lending Program***

The Pension Trust Funds participate in securities lending programs. Under these programs, the Trusts receive a fee for allowing brokerage firms to borrow certain securities for a predetermined period of time, securing such loans with cash or collateral typically equaling 102% to 105% of the fair value of the security borrowed. The collateral securities cannot be pledged or sold by

Pension Reserve Investment Trust (PRIT) unless the lending agent(s) default. The lending agents are required to indemnify PRIT in the event that they fail to return the securities on loan (and if the collateral is inadequate to replace the securities on loan) or if the lending agents fail to perform their obligations as stipulated in the agreements. There were no losses during the years end June 30, 2003 and 2002 resulting from default of the lending agents. At June 30, 2003, the fair value of the securities on loan from PRIT was approximately $2,000,097,000. The fair value of the collateral held by PRIT amounted to $2,064,954,000 at June 30, 2003, of which $408,000,000 was cash.

D. *Receivables*

Receivables are stated net of estimated allowances for uncollectible accounts. Reimbursements due to the Commonwealth for its expenditures on federally funded reimbursement and grant programs are reported as “Due from federal government.”

E. *Due from Cities and Towns*

Represents reimbursement due to the Commonwealth for its expenditures on certain programs for the benefit of cities and towns.

F. *Dedicated Revenue*

The Commonwealth has various streams of dedicated revenues reflected in non-budgeted fund activity. Approximately $1.9 billion in revenues from federal grants passed through the Federal Grants Fund representing the greatest source of dedicated revenues. The largest pledge of tax revenues apportions a “dedicated sales tax” amounting to 1% of applicable sales in the Commonwealth directly to the Massachusetts Bay Transportation Authority (MBTA). Total dedicated sales tax revenue directed to the MBTA in FY03 was approximately $684,281,000. Other major dedicated tax revenue streams include surcharges from areas contiguous to convention centers to support such centers’ operations, motor fuels taxes to support highway construction, repairs and maintenance and cigarette taxation to support health and human service costs.

G. *Inventories*

The costs of materials and supplies are recorded as expenditures in Governmental Funds when purchased. Such inventories are not material in total to the financial statements and therefore are not presented.

H. *General Fixed Assets*

General fixed asset acquisitions are recorded as expenditures in the acquiring fund and capitalized in the General Fixed Assets Account Group in the year purchased. General fixed assets are recorded at historical cost, or at estimated historical cost if actual historical cost is not available. Donated fixed assets are recorded at estimated fair market value at the date of donation.

The cost of normal maintenance and repairs that do not add to the value of the assets or materially extend asset lives are not capitalized. Improvements are capitalized.

The Commonwealth capitalizes all land except land associated with infrastructure. It capitalizes buildings and equipment, including computer software, with a cost in excess of $100,000 and $50,000 respectively at the date of acquisition and with an expected useful life greater than one year. Public domain general fixed assets and infrastructure (roads, bridges, tunnels, dams, water and sewer systems, etc.) are not capitalized. Interest incurred during construction is not material and is not capitalized. No depreciation is provided on general fixed assets for FY03.

I. *Interfund / Intrafund Transactions*

During the course of its operations, the Commonwealth records transactions between funds and/or between departments. On the statutory basis, transactions between Governmental and Fiduciary Fund Types are recorded as adjustments to the funds' cash accounts. As a result, a fund may report a deficiency in cash and short-term investments.

Transactions of a buyer/seller nature between departments within a fund are not eliminated.

Transfers in and out net to approximately $3,829,000 due to higher education non-appropriated fund activity, which is not included in the combined statements – statutory basis.

J. *Risk Management*

The Commonwealth does not insure for state employees workers' compensation, casualty, theft, tort claims and other losses. Such liabilities are not recognized on the statutory basis until encumbered and/or processed for payment. For employees workers' compensation, the Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury or property damages, Chapter 258 of the Massachusetts General Laws (General Laws) limits the risk assumed by the Commonwealth to $100,000 per occurrence, in most circumstances. The Group Insurance Commission administers contributory health care and other insurance programs for the Commonwealth's employees and retirees.

The Commonwealth has entered into agreements for insurance for Central Artery/Tunnel Project workers' compensation and certain other claims that may arise in the course of the Project. This special arrangement has been approved by the Federal Highway Administration as a cost-effective method to fund current and potential future claims by contractors, workers, and other parties affected by the project. Pursuant to the agreement, the Commonwealth conveys a sum of money to an agent each month. This amount includes both federal and state share. The agent manages and settles all claims. At the conclusion of the program, the balance remaining, if any, will be returned to the Commonwealth and the federal government. The monthly amount conveyed to an agent is accounted for (on the statutory basis of accounting) as an expenditure in the Federal Highway Capital Projects Fund.

K. *Encumbrances*

Encumbrance accounting is utilized in the Governmental Fund Types as a significant aspect of budgetary control. The full amounts of purchase orders, contracts and other commitments of appropriated resources are encumbered and recorded as deductions from appropriations prior to actual expenditure, ensuring that such commitments do not exceed appropriations. Encumbrances outstanding at year-end for goods or services received on or before June 30 are reported as expenditures and statutory basis liabilities as a component of accounts payable.

L. *Fringe Benefit Cost Recovery*

The Commonwealth appropriates and pays the fringe benefit costs of its employees and retirees through the General Fund. These fringe benefits include the costs of employees' health insurance, pensions, unemployment compensation, and other costs necessary to support the state work force. As directed by Chapter 29, Sections 5D and 6B(f) of the Massachusetts General Laws, these costs are assessed to other funds based on their payroll costs, net of credits for direct payments. Since these fringe benefit costs are not appropriated in the budget, the required assessment creates a variance between budget and actual expenditures at year-end. The fringe benefit cost recoveries of $157,406,000 in the budgeted funds result from costs assessments of $114,452,000 in the governmental fund types and the expendable trust funds. The remainder of $42,954,000 is assessed to the higher education non-appropriated activity, which is not included in the statutory basis financial report.

M. *School Construction Grants*

The Commonwealth, through legislation, is committed to reimburse certain cities, towns and regional school districts for a portion of their debt service costs for school construction and renovation. These costs are recorded as expenditures when paid.

N. *Compensated Absences*

Employees are granted vacation and sick leave in varying amounts based on collective bargaining agreements and state laws. Upon retirement, termination or death, certain employees are compensated for unused vacation and sick leave (subject to certain limitations) at their then-current rate of pay. Vacation and sick leave are recorded as expenditures when paid.

O. *Lottery Revenue and Prizes*

Ticket revenues are recognized when sold and prizes awarded by the Massachusetts Lottery Commission are recognized as drawings are held.

P. *Fund Balances*

The Commonwealth reports fund balances as reserved where legally restricted for a specific future use. Otherwise, these balances are considered unreserved.

Fund balance has been reserved as follows:

"Reserved for continuing appropriations" – are unexpended amounts in appropriations, which the Legislature has specifically authorized to be carried into the next FY.

"Reserved for Commonwealth stabilization" – are amounts set aside in the Commonwealth Stabilization Fund in accordance with 5C of Chapter 29 of Massachusetts General Laws.

"Reserved for debt service" – are amounts held by fiscal agents or the Commonwealth to fund future debt service obligations.

"Reserved for employees' pension benefits" – are the net assets of the Commonwealth's public employee retirement systems which cannot be used for any other purpose.

"Reserved for unemployment benefits" – are amounts reserved for payment of unemployment compensation.

"Reserved for capital projects" - are amounts reserved for capital projects.

Unreserved fund balance is segregated into two components:

"Designated for specific purpose" – are all unreserved fund balances for which the Legislature or Executive Branch has evidenced an intention to restrict for a specific purpose.

"Undesignated" – consists of cumulative surpluses or deficits of the Governmental Fund Types not otherwise designated.

Q. *Reclassification*

Certain reclassifications have been made to the FY 2002 account balances to conform to the presentation used in FY03.

3. BUDGETARY CONTROL

State finance law requires that a balanced budget be approved by the Governor and the Legislature. The Governor presents an annual budget to the Legislature which includes estimates of revenues and other financing sources and recommended expenditures and other financing uses. The Legislature, which has full authority to amend the budget, adopts an expenditure budget by appropriating monies at the individual appropriation account level in an annual appropriations act.

Before signing the appropriations act, the Governor may veto or reduce any specific item, subject to legislative override. Further changes to the budget established in the annual appropriations act may be made via supplemental appropriations acts or other legislative acts. These must also be signed by the Governor and are subject to the line item veto.

In addition, Massachusetts General Laws authorize the Secretary of Administration and Finance, with the approval of the Governor, upon determination that available revenues will be insufficient to meet authorized expenditures, to withhold allotments of appropriated funds which effectively reduce the account's expenditure budget.

The majority of the Commonwealth's appropriations are non-continuing accounts which lapse at the end of each fiscal year. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for spending in the current fiscal year. In addition, the Legislature may direct that certain revenues be retained and made available for spending within an appropriation. Fringe benefits and other costs which are mandated by state finance law are not itemized in the appropriation process and are not separately budgeted.

Because revenue budgets are not updated subsequent to the original appropriation act, the comparison of the initial revenue budget to the subsequent, and often modified, expenditure budget can be misleading. Also, these financial statements portray fund accounting with gross inflows and outflows, thus creating a discrepancy to separately published budget documents. In conducting the budget process, the Commonwealth excludes those interfund transactions that by their nature have no impact on the combined fund balance of the budgeted funds.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

During FY03, the Commonwealth experienced a continued downturn in certain budgeted revenues. The revenue estimates, under the provisions of section 5D of Chapter 29 of the General Laws, were determined to be insufficient to meet all of the expenditures authorized for FY03. Therefore, in accordance with section 9C of said Chapter 29, the Secretary for Administration and Finance notified the Governor and the House and Senate Committees on Ways and

Means of the amount of the probable deficiency of revenue. In accordance with the Governor's authority under said section 9C, the Governor reduced allotments under section 9B of said Chapter 29. The amount of this reduction was proposed to be $419,934,000. However, the Legislature enacted Section 74 of Chapter 4 of the Acts of 2003, which directed the Comptroller to transfer the amount of reductions proposed to the General Fund that would not cause a fund to go into deficit. The amount so transferred was $73,914,000. Furthermore, the FY04 General Appropriation Act (Chapter 26, Section 167 of the Acts of 2003), amended section 9C, directing the Governor to notify the Legislature in writing as to the reasons for and the effect of any reductions. Alternatively, the Governor may propose specific additional revenues to equal the deficiency. The Governor may also propose to transfer funds from the Stabilization Fund to cure such deficiency. This proposal must be delivered to the Legislature 15 days before any reductions take effect.

The following table summarizes budgetary activity for FY03 (amounts in thousands):

	Revenues	Expenditures
General Appropriation Act, Chapter 184 of the Acts of 2002:		
Direct appropriations	$ 21,680,409	$ 21,684,096
Estimated revenues, transfers, direct appropriations retained revenue appropriations, interagency chargebacks and appropriations carried forward from FY2002	1,312,749	1,312,749
Total Original Budget	$ 22,993,158	$ 22,996,845
Supplemental Acts of 2002:		
Chapter 300	-	2,781
Chapter 429	-	300
Supplemental Acts of 2003:		
Chapter 4	-	8,463
Chapter 6	-	62,338
Chapter 12	-	2,000
Total Before June 30, 2003	$ 22,993,158	$ 23,072,727
Supplemental Acts of 2003, passed after June 30, but for FY03:		
Chapter 55	-	25,138
Total Budgeted Revenues and Expenditures per Legislative Action	$ 22,993,158	$ 23,097,865
Plus: Transfers of Revenues and Expenditures (including rounding)	-	1,088,092
Budgeted Revenues and Expenditures as Reported	$ 22,993,158	$ 24,185,957

The following table identifies the interfund activity from budgeted sources and uses to reconcile forecasts prepared during the budget process to the results presented in these statements: (amounts in thousands)

	Revenues and Other Financing Sources	Expenditures and Other Financing Uses
Actual as presented in the combined budget and actual statement - statutory basis	$ 25,297,687	$ 25,749,601
Adjustments to revenues and expenditures		
Transfer to the Intragovernmental Service Fund Revenues	(117,223)	(117,223)
Adjustments to other financing sources and uses:		
Fringe benefit cost assessments	(48,290)	(48,290)
Year-end Stabilization Transfer	(75,673)	(75,673)
Transfer from the Intragovernmental Service Fund to the General Fund	(2,661)	(2,661)
Transfer from the Revenue Maximization Fund to the General Fund	(1,259)	(1,259)
RMV License Plates	(2,222)	(2,222)
Transfer from the General Fund to the Children's and Seniors' Health Fund	(27,714)	(27,714)
Stabilization transfers to the General Fund	(550,000)	(550,000)
Transfer from the RatePayer Parity Fund to the General Fund	(31,859)	(31,859)
Transfer from the Massachusetts Clean Elections Fund to the General Fund	(23,129)	(23,129)
Transfer from the Tobacco Settlement Fund to the Childrens' & Seniors' Health Fund	(120,000)	(120,000)
Transfer from the Workforce Training Fund to the General Fund	(12,000)	(12,000)
Transfer from the Health Protection Fund to the General Fund	(6,500)	(6,500)
Transfer from the Caseload Increase Mitigation Fund to the General Fund	(6,500)	(6,500)
Transfers per MGL Chapter 29, Section 9C to the General Fund, as adjusted by provisions of Chapter 4 of the Acts of 2003, Section 74	(73,914)	(73,914)
Retroactive Transfer of Trusts pursuant to Chapter 4 Section 76	(110,074)	(110,074)
Fund Consolidation Transfers - Local Aid Fund	(1,802,426)	(1,802,426)
Fund Consolidation Transfers - Minor Budgeted Funds	(293,001)	(293,001)
Transfer to Caseload Mitigation Increase Fund	(5,992)	(5,992)
Other	(82)	(82)
Actual as presented on budgetary documents	$ 21,987,168	$ 22,439,082

The section divider for the budgeted funds contains a list of budgeted funds grouped by categories.

The Office of the Comptroller has the responsibility to ensure that budgetary control is maintained on an individual appropriation account basis. Budgetary control is exercised through the state accounting system, Massachusetts Management Accounting and Reporting System (MMARS). Encumbrances and expenditures are not allowed to exceed the appropriation account's spending authorization.

The FY02 General Appropriation Act adjusted the calculation of permissible tax revenues under Massachusetts General Laws Chapter 62F. Effective on July 1, 2003, the Commissioner of Revenue must calculate the difference between cumulative net state tax revenues and cumulative permissible tax revenues on a quarterly basis instead of on an annual basis. For any quarter in which cumulative net state tax revenues exceed permissible tax revenues as certified by the Commissions of Revenue, the Comptroller will transfer this excess from the General Fund to a temporary holding fund contained within the Stabilization Fund. The FY04 General Appropriation Act amended this language to say that in any year when the Stabilization Fund is required to pay current expenses of the Commonwealth, any balance within the temporary holding fund contained within the Stabilization Fund will reimburse the Stabilization Fund. Any funds remaining in the temporary holding fund at the end of the fiscal year are to be transferred to the General Fund and include as part of the calculation of consolidated net surplus.

Also as part of the FY04 General Appropriation Act, the Legislature redefined consolidated net surplus to include all budgeted funds. Along with this action, the Legislature closed 51 budgeted, capital projects and trust funds. All of the future activity in these funds will be reported in the General Fund. Several other minor funds were also moved from budgeted funds to non-budgeted funds or trust funds.

4. DEPOSITS AND INVESTMENTS

The Commonwealth maintains a cash and short-term investment pool that is available for use by all funds. Each fund type's net equity in this pool is displayed on the combined balance sheet as either "Cash and short-term investments" or "Deficiency in cash and short-term investments." The investments of the Pension Trust Funds are held in a trust.

The Office of the Treasurer and Receiver-General (Treasury) manages the Commonwealth's short-term investment pool. Statutes authorize investment in obligations of the U.S. Treasury, authorized bonds of all states, banker's acceptances, certificates of deposit, commercial paper rated within the three highest classifications established by Standard & Poor's Corporation and Moody's Commercial Paper Record and repurchase agreements that any of these obligations secure. Such investments are carried at cost, which approximates fair value.

The pooled cash and short-term investments at June 30, 2003 are as follows (amounts in thousands):

	Carrying Value
Cash and Certificates of deposit	$ 1,275,627
Short-term investments:	
Short-term investment pool	2,532,097
Repurchase agreements and other	219
Money market investments	740,618
Commercial Paper	151,865
Total	$ 4,700,426

Pooled cash and short-term investments include the following:

Cash and short-term investments	$ 4,938,255
Cash with fiscal agent	337,306
Cash on Deposit with U. S. Treasury	490,652
Deficiency in cash and short-term investments	(912,442)
Total	$ 4,853,771

The Pension Trust Funds have invested a significant portion of their portfolios into a trust, which pools assets for investment purposes and allocates returns on these investments in proportion to each fund's share of the pool. The fund includes money held on behalf of other governments.

The investments are carried at fair value. At June 30, 2003, they are as follows (amounts in thousands):

On behalf of the Health Care Security Trust Fund, the Pension Reserve Management Board has invested a significant portion of their portfolio into a

	Amount
Investments:	
Equity securities	$ 11,440,582
International investments	6,046,366
U.S. government and government agency securities	2,094,776
Fixed income securities	4,421,751
Real estate	1,895,280
Alternative investments	2,198,642
Total	$ 28,097,397

trust, which pools assets for investment purposes and allocates returns on these investments in proportion to the fund's share of the pool.

The investments are carried at fair value. At June 30, 2003, they are as follows (amounts in thousands):

	Amount
Investments:	
Equity securities	$ 252,252
U.S. government and government agency securities	40,594
International investments	71,055
Fixed income securities	101,525
Alternative investments	88
Real estate	11,274
Total	$ 476,789

A. *Financial Instruments with Off-Balance Sheet Risk*

Certain investments of the Commonwealth may involve a degree of risk not accounted for on the respective financial statements. A description of such "off-balance sheet risks" are as follows:

Forward Currency Contracts

The Pension Trust Funds enter into forward currency contracts to hedge the exposure to change in foreign currency exchange rates on foreign portfolio holdings. The market value of the contract will fluctuate with changes in currency exchange rates. Risks may arise upon entering these contracts from the potential inability of counterparties to meet the terms of their contracts and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar.

When the contract is closed, the Pension Trust Funds record a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed. Fluctuations in the value of forward currency contracts are recorded as unrealized gains or losses by the Pension Trust Funds.

Futures Contracts

The Pension Trust Funds may purchase and sell financial futures contracts to hedge against changes in the values of securities the fund owns or expects to purchase. Upon entering such contracts, they must pledge to the broker an amount of cash or securities equal to a percentage of the contract amount.

The potential risk is that the change in the value of futures contracts primarily corresponds with the value of underlying instruments, which may correspond to the change in value of the hedged instruments. In addition, there is a risk that PRIT may not be able to close out its future positions due to a non-liquid secondary market. Risks may arise from the potential inability of a counter-party to meet the terms of a contract and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar. The Pension Trust Funds may also invest in financial futures contracts for non-hedging purposes.

Payments are made or received by the Pension Trust Funds each day, depending on the daily fluctuations in the value of the underlying security and are recorded as unrealized gains or losses. When the contracts are closed, the Pension Trust Funds recognize a realized gain or loss.

Options

PRIT is also engaged in selling or "writing" options. The Pension Trust Funds, as writers of options, may have no control over whether the underlying securities may be sold (call) or purchased (put) and, as a result, bears the market risk of an unfavorable change in the price of the security underlying the written option. As of June 30, 2003, there were no material options outstanding.

5. SHORT-TERM FINANCING AND CREDIT AGREEMENTS

Massachusetts General Laws authorize the Treasurer to issue temporary notes in anticipation of revenue or bond financing. When this short-term debt does not meet long-term financing criteria, it is classified as a fund liability. Short-term debt may be issued on either a stand-alone basis or through a commercial paper program maintained by the Commonwealth.

A. *General Fund*

The balance of revenue anticipation notes (RANs) outstanding may fluctuate during a fiscal year, but must be reduced to zero at June 30. During FY03, the Commonwealth issued RANs through its commercial paper program on a periodic basis to meet cash flow needs. Up to $700,000,000 of RANs were issued during the year. All RANs were retired before the end of June 2003.

B. *Capital Projects Funds*

The Commonwealth may issue bond anticipation notes (BANs) to temporarily finance its capital projects. BANs may be issued either on a stand-alone basis or through the Commonwealth's commercial paper program.

During FY03 the Commonwealth periodically issued BANs through the commercial paper program, beginning in August 2002. BANs were rolled over and paid down at various times during the fiscal year. No more than $507,100,000 of BANs were outstanding under the commercial paper program at any time, of which all $507,100,000 were outstanding on June 30, 2003.

On September 5, 2001, $350,000,000 of General Obligation BANs were issued to finance costs associated with the development of Convention Centers in Boston, Worcester and Springfield, and to retire a portion of BANs issued prior to the sale. These notes remained outstanding at year-end, but were subsequently retired on September 2, 2003 through the issuance of $550,000,000 in General Obligation BANs that will mature on January 15, 2004.

On March 28, 2002, $180,000,000 in General Obligation BANs were also issued to finance costs of the Central Artery / Tunnel Project, in advance of receiving certain contributions from the Massachusetts Port Authority (Massport), which were retired in April, 2003 through the issuance of commercial paper. During June 2003, Massport delivered to the Commonwealth $104,900,000 in satisfaction of a portion of the terms of the commercial paper BANs. $75,100,000 remains outstanding as of June 30, 2003. It is expected that $50,000,000 of these commercial paper BANs will be retired on December 31, 2003 with proceeds from a payment from Massport. A final payment of $50,000,000 is due from Massport on or before December 31, 2004, which will retire the remaining commercial paper BANs.

C. *Letter-of-Credit Facilities*

During FY03, the Commonwealth maintained a letter-of-credit agreement with a bank in order to provide credit and liquidity support for its commercial paper program. The letter of credit was available to secure up to $200,000,000 of Commonwealth commercial paper plus interest thereon. Advances were available, subject to certain limitations and bearing interest at the bank rate as defined, in anticipation of revenue or bond proceeds repayable by the following June 30, subject to extension in certain circumstances at the Commonwealth's option. No such advances were drawn during the fiscal year ended June 30, 2003. The cost of the facility is approximately 0.15% on both unutilized and utilized amounts, and expires in December 2003.

D. *Line-of-Credit Facilities*

During FY03, the Commonwealth maintained line-of-credit facilities to provide liquidity support for commercial paper notes totaling $800,000,000. The Commonwealth has a total of four line-of-credit facilities to provide such liquidity support, each in the amount of $200,000,000. These facilities expire in September and December of 2004, and March and September of 2005. The annual cost of these facilities ranges from 0.125% to 0.17%.

The following schedule details short – term financing and credit agreement activity for all funds for the fiscal year (amounts in thousands):

	Beginning Balance July 1, 2002	Issued / Drawn	Redeemed / Repaid	Ending Balance June 30, 2003	Credit Limit June 30, 2003
General Fund:					
Revenue Anticipation Notes	$ -	$ 700,000	$ (700,000)	$ -	$ -
Letter-of-Credit Agreements	-	-	-	-	200,000
Line-of-Credit Agreements	-	-	-	-	800,000
Subtotal - General Fund Activity	-	700,000	(700,000)	-	1,000,000
Capital Projects Funds:					
Bond Anticipation Notes	530,000	432,000	(104,900)	857,100	-
Subtotal - Capital Projects Funds Activity	530,000	432,000	(104,900)	857,100	-
Total Short-Term Financing And Credit Agreement Activity	$ 530,000	$ 1,132,000	$ (804,900)	$ 857,100	$ 1,000,000

6. LONG-TERM DEBT

Under the Constitution of the Commonwealth of Massachusetts, the Commonwealth may borrow money (a) for defense, (b) in anticipation of receipts from taxes or other sources, any such loan to be paid out of the revenue of the year in which the loan is made, or (c) by a two-thirds vote of the members of each house of the Legislature present and voting thereon. The Constitution further provides that borrowed money shall not be expended for any other purpose than that for which it was borrowed or for the reduction or discharge of the principal of the loan. In addition, the Commonwealth may give, loan or pledge its credit by a two-thirds vote of the members of each house of the Legislature present and voting thereon, but such credit may not in any manner be given or loaned to or in aid of any individual, or of any private association, or of any corporation which is privately owned or managed.

The Commonwealth has waived its sovereign immunity and consented to be sued on contractual obligations, including bonds and notes issued by it and all claims with respect thereto. However, the property of the Commonwealth is not subject to attachment or levy to pay a judgment, and the satisfaction of any judgment generally requires legislative appropriation. Enforcement of a claim for the payment of principal or interest on bonds and notes of the Commonwealth may also be subject to the provisions of federal or Commonwealth statutes, if any, enacted to extend the time for payment or impose other constraints upon enforcement.

As of June 30, 2003, the Commonwealth had three types of long-term debt outstanding.

A. *General Obligation Bonds*

General Obligation Bonds are authorized and issued primarily to provide funds for Commonwealth-owned capital projects and local government improvements. They are backed by the full faith and credit of the Commonwealth and paid from the Governmental Funds, in which debt service principal and interest payments are appropriated. Massachusetts General Laws provide for the allocation of bond proceeds to these authorizations in arrears, as expenditures are made, unless the proceeds are allocated at the time of issuance.

i. *College Opportunity Bonds*

Some Commonwealth general obligation debt is issued as College Opportunity Bonds (COBs) as authorized by the Massachusetts General Laws. Such bonds were initially issued in fiscal year 1996, and have been issued in each subsequent fiscal year, including FY03, when approximately $10,113,000, (including accretion), of such bonds were issued. Outstanding COBs have maturity dates ranging from 2003 through 2023. COBs have an accreting interest component payable at maturity. The annual accretion rate of each COB's maturity is a variable rate equal to the annual change in the Consumer Price Index (CPI) plus 2.0%. Assuming the CPI averages 3.5% during the life of the outstanding COBs the payments due at maturities of the COBs will total approximately $173,803,323, including accretion. In addition, COBs pay current interest in the amount of 0.5% per year of the initial amount still outstanding. The full faith and credit of the Commonwealth back these bonds. These bonds are sold to fund the Commonwealth's "U. Plan" which is part of a college savings program administered by the Massachusetts Educational Financing Authority. These bonds are privately placed and are structured to meet the needs of investors in this plan.

ii. *County Debt Assumed*

Chapter 38 of the Acts of 1997 and Chapter 300 of the Acts of 1998 abolished governments of several Massachusetts counties on various effective dates. As part of these provisions, the Commonwealth assumed the outstanding debt of Middlesex County on July 1, 1997, of Hampden and Worcester Counties on July 1, 1998, that of Essex County on July 1, 1999 and that of Berkshire County on July 1, 2000. The county debt assumed has become general obligation debt of the Commonwealth. As of June 30, 2003, $855,000 of these obligations remains outstanding.

iii. Variable Rate Demand Bonds

Included in the long-term debt is $1,542,615,000 of general obligation variable rate demand bonds (VRDBs) maturing from 2007 through 2030 in varying amounts. The redemption schedule for these bonds is included in the bond redemption schedule contained herein. The interest rate on the VRDBs is determined either weekly or daily based on the activity of the Commonwealth's remarketing agents, and interest is paid monthly. On any reset date holders of the VRDBs can require the Commonwealth (acting through its remarketing and tender agents) to repurchase the bonds (a "put"). The remarketing agent is authorized to use its best efforts to resell any repurchased bonds by adjusting the interest rates offered. The Commonwealth pays an annual fee to the remarketing agents equal to 0.05% of the par amount of the bonds.

Under the provisions of stand-by bond-purchase agreements entered into by the Commonwealth with certain commercial banks, the remarketing and tender agents are entitled to draw amounts sufficient to pay the purchase price of any bonds that cannot be resold. During any such period the Commonwealth is required to pay the bank(s) at an interest rate based on their respective prime lending rates. If the remarketing agent is unable to resell any put bonds within six months of the put date, the stand-by bond-purchase agreements include provisions to convert any such bonds to installment loans payable over an extended period of time, with interest payable at a rate based on the bank(s) prime lending rate(s). The stand-by bond-purchase agreements expire on various dates between December of 2003 and January of 2010. The Commonwealth is required to renew or replace these agreements as long as the VRDBs remain outstanding. The Commonwealth currently pays an annual fee to maintain these agreements, which range from 0.10% to 0.21% of the par amount of the bonds.

iv Other Variable Rate Bonds

As part of its refunding activities during FY03, the Commonwealth issued $97,455,000 of refunding bonds which pay a variable rate interest that depends on changes in the Consumer Price Index (CPI). These bonds, which pay interest every six months, are not subject to periodic remarketing, nor do bondholders have the right to "put" such bonds back to the Commonwealth.

v Action Rate Securities

Also included in the long-term debt is $401,500,000 of general obligation Auction Rate Securities (ARS) maturing in varying amounts from 2020 through 2030. The interest rate payable on the bonds changes weekly as determined pursuant to specified auction procedures. Interest on the bonds is payable weekly. In the case of a failed auction (i.e., insufficient bids to clear the market) existing buyers may be required to hold their bonds with interest payable at rate equal to a percentage of an ARS industry index, up to a maximum rate of 12.0%.

B. *Special Obligation Bonds*

The Commonwealth also issues special obligation revenue bonds as authorized by Massachusetts General Laws. Such bonds may be secured by all or a portion of revenues credited to the Highway Fund and are not general obligations of the Commonwealth. At June 30, 2003, the Commonwealth had outstanding $813,045,000 of such special obligation bonds, of which $739,061,000 is allocated to debt not subject to the Commonwealth's statutory debt limit. These bonds are secured by a pledge of 6.86 cents of the 21 cent motor fuel excise tax imposed on gasoline.

In June of 2002, the Commonwealth sold $319,130,000 of special obligation revenue bonds, Series 2002A. Of this amount, $183,180,000 was issued to refund prior special obligation bonds. The remainder was used to fund capital spending in the Commonwealth. The escrow funded by the refunding bonds and related premium will be used only to secure the principal related to $190,075,000, exclusive of related call premium in previously issued special obligation bonds maturing on June 1, 2004, 2006 and 2008. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from the existing stream of motor fuel excise taxes. Interest on a portion of the newly issued refunding bonds will be paid from the proceeds of the escrow until the aforementioned prior bonds are called for redemption. This technique, which is generally referred to as a "crossover refunding," results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is used to repay the principal of the refunded bonds, such amounts will be reported in the Highway Capital Projects Fund.

C. *Federal Highway Grant Anticipation Notes*

The Commonwealth also issued Federal Highway GANs to finance current cash flow for the Central Artery/Tunnel Project in anticipation of future federal reimbursements. Section 9 through 10D of Chapter 11 of the Acts of 1997, as amended by Chapter 121 of the Acts of 1998, authorizes the Commonwealth to sell up to $1,500,000,000 in GANs. All Federal Highway Construction reimbursements and reimbursements from the federal highway construction trust funds are pledged to the repayment of the GANs. At June 30, 2003, the Commonwealth has $1,499,325,000 of GANs outstanding, including accrued interest on capital appreciation bonds with maturity dates ranging from 2005 to 2015. These notes are secured by the pledge of Federal Highway Construction Reimbursements without a general obligation pledge. Under certain limited circumstances, a portion of the revenue from the Commonwealth's motor fuels excise tax may be used to pay debt service on the GANs.

D. *Interest Rate Swap Agreements*

Objective of the Interest Rate Swap Agreements

In connection with the issuance of variable rate refunding bonds in 1997, 1998, 2001 and 2003, the Commonwealth entered into interest rate swap agreements with certain counterparties. The purpose of these agreements is to effectively fix the interest rate payable on the corresponding variable rate refunding bonds, and to achieve an all-in synthetic interest rate that is lower than the rate that could have been achieved on a natural fixed rate basis at the time the agreements were entered into.

Terms of the Interest Rate Swap Agreements

The bonds and related swap agreements have final maturities ranging from 2013 to 2021. The swaps' total notional value of $1,364,480,000 matches the par amount of the related variable rate refunding bonds. Under the swap agreements, the Commonwealth pays the relevant counterparties' fixed rates ranging from 4.15% to 4.659% and receives variable rate payments equal to the amount of variable rate payments the Commonwealth pays on the related variable rate refunding bonds. For the majority of the bonds, the variable rate interest payments are determined by remarketing agents on either a weekly or daily basis. For a small portion of the relevant bonds, the variable rate is determined based on the change in the Consumer Price Index.

The following chart details the Commonwealth's outstanding swaps and related bond issuances:

Associated Refunding Issue	Notional Amounts (thousands)	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Market Values (thousands)	Swap Termination Date	Counterparty Credit Rating
Series 1997B	$ 162,768	8/12/1997	4.659%	Actual Bond Rate	$ (28,036)	August 1, 2015	AA+/Aaa
Series 1997B	108,512	8/12/1997	4.659%	Actual Bond Rate	(17,937)	August 1, 2015	AAA/Aaa
Series 1998A & B	299,712	9/17/1998	4.174%	Actual Bond Rate	(39,753)	September 1, 2016	AAA/Aaa
Series 1998A & B	199,808	9/17/1998	4.174%	Actual Bond Rate	(23,245)	September 1, 2016	AAA/Aaa
Series 2001B & C	496,225	2/20/2001	4.150%	Actual Bond Rate	(69,776)	January 1, 2021	AAA/Aaa
Series 2003B	87,455	3/12/2003	4.500%	Actual Bond Rate	(5,340)	December 1, 2014	AA+/Aaa
Series 2003B	10,000	3/12/2003	4.500%	Actual Bond Rate	(19)	December 1, 2013	A/A2
Totals	$ 1,364,480				$ (184,107)		

Fair Market Value of the Interest Rate Swap Agreements

Swap rates for the types and remaining terms of the Commonwealth's swap agreements are generally lower (as of June 30, 2003) than those that prevailed when the various swap contracts were entered into. This is the result of two factors: (1) lower interest rates in general; and (2) the shortening of the remaining terms of the swap contracts due to the passage of time and an upward sloping yield curve for such instruments. As a result, the Commonwealth's swap agreements have an estimated fair market value of negative $184,107,000 as of June 30, 2003. If all the Commonwealth's swap agreements had been terminated as of the end of fiscal year 2003, the Commonwealth would have been required to make a payment of this magnitude. Although the Commonwealth has the option of terminating its swap agreements at any time (and either make or receive any termination payment due,) the Commonwealth's counterparties do not have such an option. Therefore, the Commonwealth would only have to make a payment of the magnitude estimated if certain termination events occurred, as described below.

Credit Risk of the Interest Rate Swap Agreements

The swap contracts require that the Commonwealth's counterparties maintain certain ratings levels. If they fail to maintain such ratings, the Commonwealth could choose to terminate the related swap agreement and receive or pay a termination payment depending on the interest rates at the time. Similarly, the Commonwealth is required to maintain a certain credit rating under the agreements, generally in the "A" category. If the Commonwealth's rating fell below those levels, the Commonwealth's counterparties could choose to make variable rate payments based on a market index (instead of the actual bond rate) which would subject the Commonwealth to basis risk, as noted below.

Basis, Market and Rollover Risk of the Interest Rate Swap Agreements

Because the terms on the interest rate swap agreements require the Commonwealth's counterparties to make variable rate payments equal to those the Commonwealth makes on the related variable rate bonds, the Commonwealth is not generally subject to any basis or market risk as a result of these agreements. Under certain circumstances, such as a downgrade of the credit rating of the bonds or the enactment of tax-related legislation which causes the related bonds to trade differently, the swap agreements provide that the Commonwealth's counterparties, may, at their option, pay a variable rate that is based on one or more market indicies such as LIBOR or the BMA swap index. Under these circumstances, the Commonwealth would be subject to basis risk if these indicies varied significantly from the variable rates that were determined for the Commonwealth's variable rate demand bonds through the associated remarketing process.

The swap contracts have the same maturity dates and amortizations as the related bonds. Therefore, the Commonwealth is not subject to any rollover risk as a result of these agreements.

Termination Risk of the Interest Rate Swap Agreements

The swap contracts use the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The swap agreements are not otherwise subject to termination except at the Commonwealth's option. If one or more of the swap agreements were terminated, then related variable rate bonds would no longer be hedged and the Commonwealth would no longer be paying a synthetic fixed rate with respect to the bonds. In addition, if at the time of termination, the swap had a negative fair value, the Commonwealth would incur a loss and would be required to settle with the related counterparty or counterparties at the swaps' fair market values.

Debt service on the variable rate bonds is as follows:

Fiscal Year	Variable-Rate Bonds		Interest Rate	
Ending June 30	Principal	Interest	Swaps, Net	Total
2004	$ -	$ 28,264,150	$ 30,203,563	$ 58,467,713
2005	-	28,264,150	30,203,563	58,467,713
2006	-	28,264,150	30,203,563	58,467,713
2007	-	28,264,150	30,203,563	58,467,713
2008	2,340,000	28,229,050	30,165,409	60,734,459
2009-2013	358,785,000	130,350,992	138,563,416	627,699,408
2014-2018	722,845,000	57,648,875	61,473,058	841,966,933
2019-2023	280,510,000	9,119,417	9,803,373	299,432,790
Total	$ 1,364,480,000	$ 338,404,934	$ 360,819,508	$ 2,063,704,442

E. *Outstanding Debt*

For financial reporting purposes, long-term debt is carried at its face value, which includes discount and any issuance costs. The outstanding amount represents the total principal to be repaid. For capital appreciation bonds, the outstanding amount represents total principal and accreted interest to be repaid. When short-term debt has been refinanced on a long-term basis, it is reported as outstanding at its face amount.

The amount of long-term debt authorized but unissued is measured in accordance with the statutory basis of accounting. Only the net proceeds (exclusive of discount and costs of issuance) are deducted from the total authorized by the Legislature.

Long-term debt outstanding (including discount and issuance cost) and debt authorized and unissued at June 30, 2003 is as follows (amounts in thousands):

Purpose	Bonds Outstanding	Fiscal Year Maturities	Authorized and Unissued
GANs	$ 1,499,325	2005-2015	$ -
Capital Projects:			
General	5,242,836	2004-2022	4,647,475
Highway	7,928,824	2004-2031	3,013,610
Local Aid	1,229,097	2004-2022	119,223
Other	62,424	2004-2022	941,273
	14,463,181		8,721,581
Total	$ 15,962,506		$ 8,721,581

Interest rates on the Commonwealth's debt outstanding at the end of FY03 ranged from 0.0% to 8.0%.

Changes in long-term debt outstanding (including discount and issuance cost) and bonds authorized - unissued for the year ended June 30, 2003 are as follows (amounts in thousands):

	Bonds Outstanding	Authorized and Unissued
Balance July 1, 2002	$ 14,955,135	$ 8,483,658
General and special obligation bonds:		
Principal, less discount and issuance costs	1,911,201	(1,911,201)
Net premium and issuance costs	(65,743)	-
General obligation refunding bonds:		
Principal on Refunding Bonds	3,122,435	-
Principal on Refunded Bonds	(3,227,427)	-
Retired discount on Refunded Bonds	4,737	-
Increase in bonds authorized	-	2,149,124
Bonds retired	(737,832)	-
Balance June 30, 2003	$ 15,962,506	$ 8,721,581

At June 30, 2003, debt service requirements to maturity for principal (including discount, capital appreciation and issuance costs) and interest including all variable rate interest not hedged by swap agreements (assumed interest rate is 5%) are as follows (amounts in thousands):

Fiscal Year Ended June 30,	Principal	Interest	Total
2004	$728,485	$791,228	$1,519,713
2005	851,827	755,822	1,607,649
2006	979,782	716,367	1,696,149
2007	1,018,407	667,569	1,685,976
2008	1,046,640	616,805	1,663,445
2009-2013	4,927,506	2,275,956	7,203,462
2014-2018	3,385,527	1,163,392	4,548,919
2019-2023	2,027,979	494,342	2,522,321
2024-2028	388,374	219,257	607,631
2029-2031	607,980	46,726	654,706
Total	$15,962,506	$7,747,464	$23,709,971

The Commonwealth issued bonds and notes through both competitive and negotiated sales during FY03. The costs for legal counsel and underwriting fees for bond sales were $667,000 and $22,758,000 respectively. In addition, the Commonwealth paid $166,000 for disclosure counsel services.

F. *Bonds Defeased Through Refunding*

As authorized by the Massachusetts General Laws, the Commonwealth advance refunded certain general obligation bonds through the issuance of $3,122,435,000 of general obligation refunding bonds (exclusive of the aforementioned special obligation refunding bonds) during FY03. Net proceeds totaling approximately $3,396,027,000 were used to purchase U.S. Government and U.S. Government Agency securities which were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore have been removed from the General Long-term Obligations Account Group. As a result of this refunding, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately $149,495,000 over the next 20 years and will experience an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately $127,753,000. At June 30, 2003, approximately $2,351,885,000 of the bonds refunded remain outstanding and are defeased.

G. *Prior Defeasance*

In prior years, the Commonwealth defeased certain general and special obligation bonds by purchasing securities (from the proceeds of refunding bonds or from surplus operating funds) and placing them in irrevocable trusts to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liabilities for the defeased bonds are not included in the financial statements. At June 30, 2003, approximately $3,615,898,000 of bonds outstanding from activities in prior fiscal years are considered defeased.

H. *Statutory Debt Limit*

The Massachusetts General Laws establish limits on the amount of direct debt outstanding. By statutorily limiting the Commonwealth's ability to issue direct debt, this limit provides a control on annual capital spending. The direct debt limit for FY03 was approximately $12,211,823,000. Outstanding debt subject to the limit at June 30, 2003 was approximately $11,566,472,000. The limit increases 5% per year.

For purposes of determining compliance with the limit, outstanding direct debt is defined to include general obligation bonds and minibonds at the amount of their original net proceeds. It excludes BANs and discount and issuance costs, if any, financed by these bonds. It also excludes special obligation bonds, GANs, refunded bonds, certain refunding bonds, debt issued by counties, and debt issued in conjunction with the MBTA forward funding.

The amounts excluded from the debt limit are as follows (amounts in thousands):

		Debt Outstanding
Balance June 30, 2003	$	15,962,506
Less amounts excluded:		
Discount and issuance cost		(68,718)
Chapter 5 of the Acts of 1992 Refunding		(10,600)
Special Obligation Principal		(748,124)
GANs Principal		(1,500,000)
County Debt Assumed		(855)
MBTA Forward Funding		(680,869)
Central Artery Tunnel		(1,386,868)
Outstanding Direct Debt	$	11,566,472

I. *Subsequent Bond Issuances*

Subsequent to year-end, the Commonwealth sold $408,015,000 of GANs refunding notes, Series 2003A. These GANs are Special Obligations of the Commonwealth. The escrow funded by the notes will be used to secure the principal related to $418,340,000 of GANs, including related call premiums, in previously issued series callable on December 15, 2008 and 2010. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from Commonwealth appropriations or the existing stream of future federal grants. Interest on the newly issued refunding notes will be paid from the proceeds of the escrow until the aforementioned prior notes are called for redemption. This technique, which is generally referred to as a “crossover refunding”, results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is issued to repay the principal of the refunded notes, such amounts will be reported in the Grant Anticipation Note Trust Fund. As a result of this transaction, the Commonwealth will reduce its debt service by $23.9 million over the next 13 years, resulting in an economic gain of $15.4 million on a present value basis.

In August of 2003, the Commonwealth sold $475,000,000 of General Obligation Bonds, Series 2003B and 2003C. The proceeds were used to fund capital spending.

In August of 2003, the Commonwealth issued an additional series of College Opportunity Bonds totaling $10,585,000. This includes an initial amount of $6,343,000 plus an expected $4,242,000 in interest to be accreted through maturity.

In October of 2003, the Commonwealth sold $271,310,000 in General Obligation Bonds, Series 2003C and $762,285,000 of General Obligation Refunding Bonds, Series 2003D. Proceeds from the Series 2003C bonds were used to fund capital spending. The proceeds of the Refunding Bonds were used to retire various outstanding General Obligation Bonds that were to mature from fiscal 2010 to 2021. The refunding will reduce the Commonwealth’s debt service by approximately $46.0 million over the next 20 years, and result in an economic gain to the Commonwealth of approximately $32.2 million on a present value basis.

7. LEASES

In order to finance the acquisition of equipment the Commonwealth has entered into various lease/purchase agreements, including tax-exempt lease purchase (TELP) agreements, which are accounted for as capital leases. Lease agreements are for various terms and contain clauses indicating that their continuation is subject to appropriation by the Legislature. For the fiscal year ended June 30, 2003, capital lease/purchase expenditures totaled approximately $33,876,000.

At June 30, 2003, the Commonwealth's aggregate outstanding liability under capital leases, the present value of the net minimum lease payments, totals approximately $165,216,000. This liability is reported in the General Long-Term Obligations Account Group. Equipment acquired under capital leases and included in the General Fixed Assets Account Group totaled approximately $172,631,000.

The Commonwealth has numerous operating lease agreements for real property and equipment with varying terms. These agreements contain provisions indicating that continuation is subject to appropriation by the Legislature.

Certain colleges have capital leases for energy projects with guaranteed energy savings. The result of these savings yields zero interest due from 2014 – 2022 on these leases.

Operating lease expenditures for the fiscal year ended June 30, 2003 were approximately $186,907,000.

The following is a schedule of future minimum payments under non-cancelable leases as of June 30, 2003 (amounts in thousands):

	Capital Leases		Operating	
	Principal	Interest	Leases	Total
2004…………	$42,283	$6,591	$172,398	$221,272
2005…………	34,295	5,270	151,071	190,636
2006…………	27,831	4,082	109,166	141,079
2007…………	21,847	2,897	80,570	105,314
2008…………	19,814	2,089	51,012	72,915
2009-2013…..	18,548	1,589	414,656	434,793
2014-2018…..	429	-	506	935
2019-2022…..	169	-	-	169
Total………..	$165,216	$22,518	$979,379	$1,167,113

8. INDIVIDUAL FUND DEFICITS

In order to resolve the deficits in the budgeted funds, the Comptroller has recommended authorization of transfers from other budgeted funds with surplus balances or a plan of fund consolidation. If these changes are adopted by the Legislature, the deficiencies will be resolved. For the Non-Budgeted Special Revenue Funds, the Comptroller has recommended similar budgeted transfers to subsidize and resolve the deficits or their consolidation into budgeted funds. Such steps require legislative action.

The Capital Projects Fund deficit reported in the following table reflects the time lag between capital expenditures and the sale of related bonds. To arrive at the combined capital projects fund balance, this individual fund deficit is offset by capital funds earmarked in the Central Artery Statewide Road and Bridge Infrastructure Fund of $936,218,000, $231,498,000 held in escrow for the Series 2002A Special Obligation ("Crossover Refunding") Bonds and $9,222,000 in reserve for the other Capital Projects Funds.

The following Budgeted, Non-Budgeted Special Revenue and Capital Projects Funds are included in the combined totals and have individual fund deficits at June 30, 2003, as follows (amounts in thousands):

Budgeted Funds:	
Highway Fund	$ 596,027
Children's and Seniors' Health Care Assistance Fund	80,032
Total Budgeted Funds	676,059
Non-Budgeted Special Revenue:	
Other:	
Government Land Bank Fund	35,097
Mosquito and Greenhead Fly Control Fund	116
Motor Vehicle Safety Inspection Trust Fund	31,730
Total Non - Budgeted Funds	66,943
Capital Projects:	
General Capital Projects Fund	263,698
Capital Investment Trust Fund	1,371
Capital Improvements and Investment Trust Fund	54,936
Convention and Exhibition Center Capital Fund	502,568
Capital Expenditure Reserve Fund	98,829
Highway Capital Projects Fund	32,057
Government Land Bank Capital Project Fund	838
Local Capital Projects Fund	1,137
Total Capital Projects Funds	955,434
Total	$ 1,698,436

9. MEDICAID COSTS

The Commonwealth provides medical care for low-income, elderly and other residents who qualify for such assistance under the federally-sponsored Medical Assistance Program (Medicaid). The Commonwealth pays the full cost of care and is reimbursed by the federal government for 50% of that cost. For the fiscal year ended June 30, 2003, the General Fund, Tobacco Settlement Fund and

Children's and Seniors' Health Fund include $5,485,112,000 in expenditures for Medicaid claims processed for payment.

The combined financial statements – statutory basis include Medicaid claims processed but unpaid at June 30, 2003, as accounts payable of approximately $143,203,000. The Commonwealth estimates its total liability, as determined in accordance with GAAP, at $547,800,000 including the amounts reported as accounts payable at June 30, 2003. This amount includes estimates of both the cost of care provided as of June 30, 2003, for which claims have not been processed and other costs. Of this amount, $195,700,000 is expected to be reimbursed by the federal government.

10. RETIREMENT SYSTEMS

A. *Primary Government*

The Commonwealth is statutorily responsible for the pension benefits for Commonwealth employees (members of the State Employees' Retirement System) and for teachers of the cities, towns, regional school districts throughout the Commonwealth and Quincy College (members of the Teachers' Retirement System, except for teachers in the Boston public schools, who are members of the State-Boston Retirement System but whose pensions are also the responsibility of the Commonwealth). The members of the retirement systems do not participate in the Social Security System.

The Commonwealth has assumed responsibility for payment of cost-of-living adjustments (COLA) for the separate (non-teacher) retirement systems of its cities, towns and counties, granted in fiscal year 1981 to 1996. The Commonwealth is statutorily required to have an actuarial valuation once every three years and every two years on a GAAP basis.

B. *Plan Descriptions*

The *State Employees' Retirement System* (SERS) is a single employer defined benefit public employee retirement system (PERS), covering substantially all employees of the Commonwealth and certain employees of the independent authorities and agencies, including the state police officers at the Massachusetts Port Authority and the Massachusetts Turnpike Authority. The SERS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand alone financial report.

The *Teachers' Retirement System* (TRS) is an agent multiple employer defined benefit PERS. The Commonwealth is a non-employer contributor and is responsible for all contributions and future benefit requirements of the TRS. The TRS covers certified teachers in cities (except the City of Boston), towns, regional school districts and Quincy College. The TRS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand-alone financial report.

Certain Commonwealth employees and current retirees employed prior to the establishment of the State Employees' Retirement System are covered on a "pay-as-you-go" basis. During the year ended June 30, 2003, the Commonwealth's pension expenditure included payments totaling $16,711,000 to current retirees employed prior to the establishment of the current plans and the non-contributory plans.

The *State – Boston Retirement System* (SBRS) is a hybrid multiple employer defined benefit PERS. SBRS provides pension benefits to all full-time employees upon commencement of employment with any of the various government agencies covered by SBRS. The Commonwealth is a non-employer contributor and is only responsible for the actual cost of pension benefits for SBRS participants who serve in the City of Boston's School Department in a teaching capacity (BTRS). The cost of pension benefits of the other participants is the responsibility of the City of Boston. SBRS is not administered by the Commonwealth and is not part of the reporting entity and a stand-alone financial report is not available.

The policy for post-retirement benefit increases for all retirees of the SERS, TRS, BTRS and COLA of local governments is subject to legislative approval.

Membership – Membership in SERS, TRS and BTRS as of January 1, 2003, the date of the most recent valuation, is as follows:

	SERS	TRS	BTRS
Retirees and beneficiaries currently receiving benefits	48,766	37,041	2,696
Terminated employees entitled to benefits but not yet receiving them	2,756	N/A	161
Subtotal	51,522	37,041	2,857
Current employees:			
Vested*	42,151	44,909	3,716
Non-vested*	40,001	44,097	2,681
Subtotal	82,152	89,006	6,397
Total	133,674	126,047	9,254

* Estimated

C. *Benefit Provisions*

Massachusetts General Laws established uniform benefit and contribution requirements for all contributory PERS. These requirements provide for retirement allowance benefits up to a maximum of 80% of a member's highest three-year average annual rate of regular compensation. Benefit payments are based upon a member's age, length of creditable service, and group creditable service, and group classification. The authority for amending these provisions is with the Legislature.

Members become vested after ten years of creditable service. A superannuation retirement allowance may be received upon the completion of twenty years of service or upon reaching the age of 55 with ten years of service. Normal retirement for most employees occurs at age 65; for certain hazardous duty and public safety positions, normal retirement is at age 55.

D. *Funding Progress*

During FY01, the Legislature passed Chapter 114 of the Acts of 2000, which modified Chapter 32 of the General Laws. This modification became effective on July 1, 2001. In Chapter 114, teachers who are members of the State Teachers Retirement System, or teachers who are members of the State – Boston Retirement System before 1975, who resigned or took an unpaid leave of absence because of maternity leave will be allowed to "buy back" into the fund up to a maximum of four years. The member must pay the amount determined by the Retirement Board by December 31, 2001 to qualify, as long as the member has worked longer than ten years. If the member completes ten years of service after December 31, 2001, payment can be made within 18 months of completion of ten years of service. In addition, the law creates a superannuation retirement benefit program for all teachers hired on or after July 1, 2001. This program has a contribution rate of 11 percent of regular compensation. To be eligible for the alternative benefit at retirement, the teacher must have completed thirty years of eligible service. All previous members may elect to participate in the program, as long as they participate with the equivalent of a minimum of five years of employee contributions at the new rate. If the member retires before five years, the teacher must pay into the system, the amount that would have been paid in one lump sum, or in installments as the Board may prescribe. The alternative benefit is calculated as the percentage of average compensation determined under the current formula increased by 2% of the average annual compensation for each full year of service in excess of 24 years. The election to participate is irrevocable.

The SERS, TRS and BTRS actuarial determined contributions were computed as part of the actuarial valuation as of January 1, 2001. These assumptions remained the same for the January 1, 2003 valuation. The Commonwealth revised the actuarial assumptions used in the calculation of contribution requirements and Unfunded Actuarial Liability (UAL) effective January 1, 2001. The revised actuarial assumptions were the result of an experience study performed for the Commonwealth for the period 1995 to 1999 concluded in FY01.

The actuarial value of assets used to derive the UAL from January 1, 1990 to January 1, 1996 reflected the market value of plan assets. Beginning the January 1, 1998 actuarial valuation, the Commonwealth began implementing a method that averages realized and unrealized asset gains and losses over 5 years.

The most significant assumptions for the actuarial valuation are investment return and rate of salary increase. The valuation as of January 1, 2003 assumes an investment return rate of 8.25% per year. The salary increase is based on years of service and may also vary by age and job groups. The rate of salary increase assumption ranges from 4.75% to 12.00%. Other assumptions include mortality, disability, turnover and retirement rates, along with cost of living increase.

The following table presents the schedule of funding progress as presented in the most recent actuarial valuations at the dates indicated (amounts in thousands):

Actuarial Valuation as of January 1	Actuarial Value of Plan Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability (UAL)	Funded Ratio %	Annual Covered Payroll *	UAL as a % of Covered Payroll
State Employees' Retirement System						
2003	$ 13,947,000	$ 17,551,000	$ 3,604,000	79.5 %	$ 3,779,000	95.4 %
2002	15,002,000	15,961,000	959,000	94.0	4,034,000	23.8
2001	13,922,000	15,170,000	1,248,000	91.8	3,700,000	33.7
2000	13,364,000	14,138,000	773,000	94.5	3,472,000	22.3
1998	9,914,000	11,361,000	1,447,000	87.3	3,111,000	46.5
1996	7,366,000	9,441,000	2,075,000	78.0	2,989,000	69.4
1995	5,879,000	8,602,000	2,723,000	68.3	2,992,000	91.0
1993	5,071,000	8,738,000	3,667,000	58.0	2,919,000	125.6
1992	4,699,000	7,303,000	2,604,000	64.3	2,638,000	98.7
Teachers' Retirement System						
2003	14,762,000	22,892,000	8,129,000	64.5	4,406,000	184.5
2002	15,712,000	20,620,000	4,908,000	76.2	4,264,000	115.1
2001	14,390,000	18,170,000	3,779,000	79.2	4,072,000	92.8
2000	13,681,000	16,420,000	2,739,000	83.3	3,704,000	73.9
1998	10,170,000	13,095,000	2,925,000	77.7	3,175,000	92.1
1996	7,553,000	10,252,000	2,699,000	73.7	2,810,000	96.0
1995	6,014,000	9,712,000	3,698,000	61.9	2,667,000	138.7
1993	5,142,000	8,921,000	3,779,000	57.6	2,428,000	155.6
1992	4,784,000	8,706,000	3,922,000	55.0	2,032,000	193.0
State - Boston Retirement System (Boston Teachers)						
2003	919,000	1,918,000	998,000	47.9	387,000	257.9
2002	984,000	1,756,000	772,000	56.0	370,000	208.6
2001	918,000	1,502,000	583,000	61.1	304,000	191.8
2000	860,000	1,381,000	521,000	62.3	285,000	182.8
1998	699,000	1,219,000	520,000	57.3	285,000	182.5
1996	549,000	1,025,000	476,000	53.6	274,000	173.7
1995	438,000	833,000	395,000	52.6	232,000	170.3
1993	370,000	743,000	373,000	49.8	206,000	181.1
1992	342,000	759,000	417,000	45.1	184,000	226.6

* - The covered payroll amounts approximate the employer payroll.

E. *Pension Actuarial Valuation*

The Commonwealth's pension actuarial valuation was performed as of January 1, 2003 pursuant to Chapter 32 of the General Laws of the Commonwealth of Massachusetts and based on the plan provisions at that time.

F. *Contributions Required and Contributions Made*

The Commonwealth was financially responsible for the COLA granted to participants in the 104 retirement systems of cities, towns and counties in fiscal year 1981 to 1996. Chapter 17 of the Acts of 1997 effective for fiscal year 1998 transferred the responsibility for funding COLAs for separate (non-teacher) retirement systems of cities and towns to the respective system. Any future COLA granted by the Legislature to employees of these plans will be the responsibility of the individual system. The individual employer governments are also responsible for the basic pension benefits. The retirement systems are not administered by the Commonwealth and are not part of the reporting entity. The actuarial accrued liability for COLA as of January 1, 2003 was $670,000,000.

The retirement systems' funding policies have been established by Chapter 32 of the Massachusetts General Laws. The Legislature has the authority to amend these policies. The annuity portion of the SERS, TRS and BTRS retirement allowance is funded by employees, who contribute a percentage of their regular compensation. Costs of administering the plan are funded out of plan assets.

Member contributions vary depending on the most recent date of membership:

Hire Date	% of Compensation
Prior to 1975	5% of regular compensation
1975 – 1983	7% of regular compensation
1984 to 6/30/96	8% of regular compensation
7/1/96 to present	9% of regular compensation
7/1/96 to present	12% of regular compensation (State Police)
7/1/01 to present	11% of regular compensation (for teachers hired after 7/1/01 and those accepting provisions of Chapter 114 of the Acts of 2000)
1979 to present	An additional 2% of regular compensation in excess of $30,000.

The Commonwealth's contribution for the pension benefit portion of the retirement allowance of SERS and TRS and required payments to cover BTRS and COLA contributions were originally established on a "pay-as-you-go" basis. As a result, amounts were appropriated each year to pay current benefits, without a systematic provision to fully fund future liabilities already incurred. Beginning in fiscal year 1988, the Commonwealth enacted the Pension Reform Act of 1987 and addressed the unfunded liability of SERS, TRS and its participation in SBRS and its COLA obligation. Chapter 32, Section 22C of General Laws enacted in 1998 called for the payment of normal cost plus a level amortization payment of UAL such that the UAL is reduced to zero by June 30, 2018.

This legislation also directed the Secretary of Administration and Finance to prepare a funding schedule to meet these requirements, and to update this funding schedule every three years on the basis of new actuarial valuation reports prepared under the Secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule. Under the current schedule proposed on March 1, 2002, the amortization payments are designed to eliminate the unfunded liability by fiscal year 2023 on a 4.15% increasing basis. Contributions by the Commonwealth of $813,660,000 were made during the fiscal year ended June 30, 2003. Of this amount $34,073,000 represents payments for COLA granted to participants in retirement systems of cities, towns and counties.

GAAP requires that pension expenditures (costs) be based on an acceptable actuarial cost method and that they be not less than:

- Normal cost plus amortization of net pension obligation cost
- Interest and amortization on any unfunded prior service costs

The funding schedule discussed above follows an acceptable actuarial funding methodology to compute normal cost and the unfunded accrued actuarial liability.

The following table presents the schedule of employer contributions (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
State Employees' Retirement System								
2003	$ 397,698	$ (117,299)	$ (96,940)	$ 377,338	$ 280,929	$ 1,325,401	71 %	74 %
2002	215,795	(111,506)	(92,152)	196,441	266,660	1,421,811	124	136
2001	275,204	(109,731)	(133,387)	298,861	320,381	1,351,592	116	107
2000	352,084	(108,400)	107,190	350,873	367,000	1,330,071	104	105
1999	319,454	(103,188)	98,556	314,822	378,000	1,313,944	118	120
1998	261,255	(83,446)	77,180	254,989	494,289	1,250,766	189	194
1997	246,037	(65,478)	41,889	222,448	463,590	1,011,466	188	208
1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
1994	266,564	(18,448)	9,152	257,268	398,900	372,227	150	155
1993	243,587	(5,539)	2,694	240,742	402,100	230,595	165	167
1992	252,687	136	(65)	252,758	323,700	69,237	128	128
Teachers' Retirement System								
2003	651,021	(83,468)	(68,980)	636,534	417,204	792,400	64	66
2002	411,225	(82,377)	(68,079)	396,927	410,143	1,011,729	100	103
2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
1994	247,460	(15,975)	7,925	239,410	322,100	282,381	130	135
1993	225,838	(9,946)	4,837	220,729	296,100	199,691	131	134
1992	223,041	(4,996)	2,384	220,429	282,300	124,320	127	128
Boston Teachers Retirement System								
2003	76,151	3,411	2,819	76,743	52,944	(65,142)	70	69
2002	94,003	(67)	(56)	93,992	51,833	(41,343)	55	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	(18,697)	77	77
1999	53,453	(989)	944	53,409	36,000	(5,426)	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102
1994	22,448	(1,216)	603	21,835	28,000	21,365	125	128
1993	20,463	(650)	316	20,129	27,200	15,200	133	135
1992	26,530	(634)	303	26,199	26,400	8,129	100	101

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

G. *Subsequent Event – Change in Budgetary Funding for Pensions and Transfer of Assets*

On June 30, 2003, the Commonwealth enacted the General Appropriation Act (GAA) for fiscal year 2004. Within the Act, the Commonwealth changed its funding mechanism for its pension obligations, moving the funding "off – budget." The original pension funding schedule called for an $832.3 million appropriation. However, the fiscal year 2004 GAA amended the General Laws to allow annual pension appropriations to include the scheduled amount less the value of any capital assets transferred to the pension liability fund. The fiscal 2004 GAA funded the $832.3 million pension obligation using $687.3 million in cash from operating revenues and the transfer to the pension liability fund of the Commonwealth from the Massachusetts Convention Center Authority the Hynes Convention Center and the Boston Common Garage, valued at $145.0 million.

H. *Post-retirement Health Care and Life Insurance Benefits*

In addition to providing pension benefits, under Chapter 32A of the Massachusetts General Laws, the Commonwealth is required to provide certain health care and life insurance benefits for retired employees of the Commonwealth, housing authorities, redevelopment authorities, and certain other governmental agencies. Substantially all of the Commonwealth's employees may become eligible for these benefits if they reach retirement age while working for the Commonwealth. Eligible retirees are required to contribute a specified percentage of the health care benefit costs which is comparable to contributions required from employees. The Commonwealth is reimbursed for the cost of benefits to retirees of the eligible authorities and non-state agencies. The Commonwealth recognizes its share of the costs of providing these benefits when paid. These payments totaled approximately $251,370,000 for the fiscal year ended June 30, 2003. There are approximately 51,398 participants eligible to receive benefits at June 30, 2003.

The Commonwealth has not performed an actuarial valuation of its post-retirement health care and life insurance benefit liability. Private industry typically sees an actuarial accrued liability of 10 to 20 times the current annual payments. For the Commonwealth this would extrapolate to an actuarial accrued liability of $2.5 billion to $5 billion.

The FY04 General Appropriation Act changed the employee contribution rates for group health insurance with the exception of current employees earning less than $35,000 and retires. Current employees as of July 1, 2003 will contribute 20% to their health insurance costs if they earn over $35,000. New employees will contribute 25%. In fiscal 2006, the contribution rates will return to 15% for all employees.

11. COMMITMENTS

A. *Regional Transit Authorities*

Under Chapter 161B of the General Laws, the Commonwealth is obligated to provide annual subsidies to certain regional transit authorities for contract assistance, debt service assistance and their net cost of service deficiencies. The Commonwealth recovers a portion of these payments through assessments to the cities and towns served. During FY03, net expenditures were $18,580,000. In addition, for FY03, the Commonwealth appropriated $19,478,000 to the regional transit authorities to cover net costs of service for the calendar year ended December 31, 2002.

The FY03 General Appropriation Act amended Chapter 161B. After July 1, 2003, bonds and notes issued by the various authorities are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

B. *MBTA and Other Authorities*

The Commonwealth continues to guarantee certain Massachusetts Bay Transportation Authority (MBTA) debt outstanding at June 30, 2003, totaling $2,833,700,000. The amount represents the residual balance of Commonwealth guaranteed debt that existed prior to the forward funding.

The MBTA's forward funding legislation provides for the MBTA to issue general obligation, revenue or other debt secured by a pledge or conveyance of all or a portion of revenues, receipts or other assets or funds of the MBTA. This new debt is not backed by the full faith and credit of the Commonwealth. Finally, the MBTA will not receive any principal or interest subsidies from the Commonwealth for the repayment of either the prior debt or new debt of the MBTA beyond the pledged revenues.

In addition to the MBTA, the Commonwealth guarantees debt of a number of Public Authorities. At June 30, 2003, the aggregate outstanding debt for which the Commonwealth is obligated to provide contract assistance support totaled approximately $909,167,000 long-term and $100,596,000 short-term.

In addition, the Commonwealth guarantees the debt of certain local governments and public higher education building authorities but does not provide contract assistance. The majority of these guarantees are for bonds outstanding for certain series' of the University of Massachusetts Building Authority. The Commonwealth guarantees these series of bonds to a maximum of $200 million.

At June 30, 2003, the Commonwealth had commitments of approximately $976,620,000 related to ongoing construction projects. The majority relate to construction funding for the Central Artery/Tunnel Project. The Central Artery/Tunnel Project continues to anticipate federal participation and payments from the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort).

C. *Saltonstall Building*

The Massachusetts Development Finance Agency (MDFA) was authorized in legislation to undertake redevelopment of the Saltonstall State Office Building and its surrounding area. Under the provisions of MDFA's bond authorization, the building is to be leased by the MDFA for a lease term of up to 50 years with extension terms permitted for an aggregate 30 more years. The MDFA renovated the building and will lease half of it back to the Commonwealth for office space and related parking for a comparable lease term. The remainder of the building and surrounding area has been redeveloped as private office space, housing and retail establishments. Upon completion, the Commonwealth will be obligated for future lease payments for space it rents. However, this obligation is not a general obligation or a pledge of credit of the Commonwealth. Though MDFA's bonds are revenue obligations, with pledges of the public and private lease payments, the Commonwealth's lease payments are due upon occupancy and are subject to annual appropriation. It is currently anticipated that the initial lease payment will be due between December of 2003 and February of 2004. The Governor filed legislation in June 2003 to fund the cost of the FY04 lease payments. The legislation is currently pending.

D. *Central Artery / Tunnel Project*

The Central Artery / Tunnel Project is the largest single component of the Commonwealth's capital program according to the finance plan filed as of October 1, 2003. The current cost estimate is $14.625 billion. The plan includes a maximum obligation of $8.549 billion from the federal government. The finance plan is currently under review.

In connection with the Central Artery / Tunnel Project, on May 8, 2000, the State Treasurer's office was advised that the staff of the Securities and Exchange Commission (SEC) conducted a formal investigation in the matter of "Certain Municipal Securities/Massachusetts Central Artery (B-1610.)" This is pursuant to a formal order of private investigation issued by the SEC.

Subsequent to year-end, on July 31, 2003, the SEC accepted offers of settlement from the Turnpike Authority and the former Turnpike Authority Chairman, which included issuance of cease-and-desist orders as a result of their failure to disclose cost increases associated with the Central Artery / Tunnel Project in 1999. In accepting those offers of settlement, the SEC considered the remedial acts undertaken by the Turnpike Authority, including generating detail monthly cost projections for the Central Artery / Tunnel Project, conducting annual reviews, employing an outside consultant to test budget assumptions and cost figures and retaining outside counsel to provide disclosure advice. No fines were imposed.

12. CONTINGENCIES

A number of lawsuits are pending or threatened against the Commonwealth, which arise from the ordinary course of operations. These include claims for property damage and personal injury, breaches of contract, condemnation proceedings and other alleged violations of law. For those cases in which it is probable that a loss will be incurred and the amount of the potential judgment can be reasonably estimated or a settlement or judgment has been reached but not paid, the Attorney General estimates the liability to be approximately $34,950,000 to be paid during FY04. No accrual has been made for this amount in the combined financial statements – statutory basis.

Under the statutory basis of accounting, workers' compensation costs are recognized when claims are presented and paid. The Commonwealth's outstanding liability for such claims at June 30, 2003 is estimated to be $287,192,000, of which approximately $40,214,000 is expected to be paid during FY04. No accrual has been made for these amounts in the combined financial statements – statutory basis.

The Commonwealth receives significant financial assistance from the federal government. Entitlement to these resources is generally contingent upon compliance with terms and conditions of the grant or reimbursement agreements and with applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all federal financial assistance is subject to financial and compliance audits. Any disallowances become liabilities of the fund which received the assistance. At June 30, 2003, the Commonwealth estimated that liabilities, if any, which may result from such audits are not material.

Chapter 200A of the Massachusetts General Laws, the Commonwealth's Abandoned Property Law, requires deposit of certain unclaimed assets into a managed Fiduciary Fund. These unclaimed assets, less $6,907,000, which is expected to be reclaimed and paid in fiscal year 2004, are to be remitted to the General Fund each June 30, where it is included as miscellaneous revenue. Amounts remitted during FY03 totaled approximately $103,803,000. Since inception, approximately $1,160,167,000 has been remitted. A portion of this amount represents a contingency, because claims for refunds can be made by the owners of the property.

A. *Tobacco Settlement*

A Master Settlement Agreement (MSA) was executed in November of 1998 between five tobacco companies and 46 states, including the Commonwealth. The MSA called for, among other things, annual payments to the states in perpetuity. These payments have been estimated to total more than $200 billion over the first 25 years, subject to various offsets, reductions, and adjustments.

In FY03, the Commonwealth received approximately $300,039,000 or 89% of the estimated amounts shown in the agreement. All of that amount was transferred to the Tobacco Settlement Fund, a budgeted fund, plus an additional $7,763,000 in interest earnings pursuant to the General Laws. The remainder was deposited into the Health Care Security Trust Fund, a non-budgeted fund. The amount transferred to the Tobacco Settlement Fund was increased in FY03 to 50% of the settlements received during the year due to changes made as part of the FY02 General Appropriation Act. The majority of expenditures from the fund this year were for Health and Human Services, Elder Affairs and Medicaid costs. Pursuant to the FY03 General Appropriation Act an additional $162,000,000 was transferred from the Tobacco Settlement Fund to fund Health and Human Services expenditures primarily in the Uncompensated Care Fund and the Children's and Seniors' Health Care Assistance Funds.

The amounts that might be payable, if any, by the Commonwealth for legal costs relating to the tobacco litigation cannot be determined at this time. The outside attorneys for the Commonwealth were awarded approximately $775,000,000 in fees to be paid over time by the tobacco companies and, therefore, were not to be paid out of the Commonwealth's award. In an early ruling in the case, the court found that the attorney's arguments may ultimately inure to the benefit of the attorneys that represented the Commonwealth in the action against tobacco manufacturers. The effect of this ruling is to increase the potential exposure for the Commonwealth from $500 million to approximately $1.3 billion. The claim is based on a contingent fee contract executed under Massachusetts General Laws, Chapter 29, Section 29E.

B. *Unemployment Compensation Fund*

The fund balance in the Unemployment Compensation Fund has declined to approximately $491 million as June 30, 2003. The Department of Employment and Training estimates that the fund will be operating at a deficit by January 2004. State law provides that in the event of a deficit in the Unemployment Compensation Fund that is not paid back by September 2004, additional revenues will be collected from employers in order to pay the interest that has accrued on the debt.

13. NON-TAX REVENUE INITIATIVES

Chapter 653, Acts of 1989, amended Chapter 29 of the Massachusetts General Laws by adding Sections 29D and 29E, which authorize certain non-tax revenue initiatives and require reporting thereon, as follows.

A. *Debt Collection*

Pursuant to Massachusetts General Laws Chapter 29, Section D, Chapter 7A Section 8, allows private debt collection agencies to engage in debt collection for the Commonwealth. The fees paid are contingency based from the proceeds collected. Collections and fees paid during FY03 were:

Department Collectors	Collections	Fees
ACS State & Local Solutions	$ 418,782	$ 83,756
Allen Daniel Associates	458,591	86,563
Collection Company of America	1,615,011	358,028
Delta Management Associates, Inc.	310,221	61,840
Glenn Associates, Inc.	566,948	107,155
Gragil Associates, Inc.	69,793	15,327
NCO Financial Systems, Inc.	1,847	179
OSI Collection Services,, Inc.	1,148,274	228,976
Walker Associates Inc.	4,758	714
Windham Professionals, Inc.	1,458,256	340,950
Total	$ 6,052,482	$ 1,283,488

Under the same program, the following amounts were collected and fess paid for institutions of higher education: (These figures are a subset of the above).

Department Collectors	Collections	Fees
Allen Daniel Associates	$ 418,918	$ 78,666
Collection Company of America	667,530	148,392
Delta Management Associates, Inc.	301,938	60,183
Glenn Associates, Inc.	566,948	107,155
NCO Financial Systems, Inc.	1,847	179
OSI Collection Services, Inc.	413,691	80,751
Windham Professionals	139,216	30,881
Total	$ 2,510,088	$ 506,207

B. *Revenue Maximization*

Pursuant to Massachusetts General Law Chapter 29 Section 29E, contractors were engaged on a contingent fee basis to assist several of the Commonwealth's departments in the identification and collection of federal and other non-tax revenues. During FY03, $235,907,000 was generated through such efforts, of which $30,289,000 was credited back to the federal government. After contractor payments of $9,327,000 the Commonwealth received $194,201,000.

C. *Revenue Optimization*

Pursuant to Chapter 184 Section 188 of the fiscal year 2003 Budget, contractors were engaged on a contingent fee basis to assist several of the Commonwealth's departments in the identification and collection of federal and other non-tax revenues. This program differs from the Revenue Maximization Program in that it authorizes departments to receive a department incentive distribution if they are successful in generating new revenue and additional fiscal program goals are met. During fiscal year 2003, approximately $1,169,000 was collected through such efforts. After contractor payments of $6,916 and fund split of $489,344, the Commonwealth had a net revenue of $673,010 to the General Fund. The RevOpt Campaign was not included in the General Appropriation Act for FY2004. However, the RevOpt Campaign will have positive lasting benefits in many areas: significantly increased non-tax revenues, increased effectiveness in cross-departmental cooperation, enhanced departmental business processes, improved ability to identify revenue opportunities, enhanced capacity to accurately track and manage contingency projects and more effectively manage non-tax revenue.

D. ***Cost Avoidance***

Pursuant to Chapter 184 of the fiscal year 2003 Budget, contractors were engaged on a contingent fee basis for the purpose of identification and pursuit of cost saving/avoidance opportunities. During FY03, $102,169,000 of state expenditures was avoided, of which $51,084,000 would have been funded by the federal government. After contractor payments of $4,639,000 the Commonwealth had a net cost saving/avoidance of $46,445,000.

E. ***Intercept***

Intercept is authorized by M.G.L. Chapter 7A Section 3 and 815 CMR 9:06. Intercept is an automated process that offsets Commonwealth payments to delinquent receivables that have been approved by the Office of the State Comptroller. During FY03, the Intercept process was enhanced by using Web based technology to accept debt files from institutions of higher education. In FY03, the Commonwealth intercepted $4,323,000 of which $1,423,000 was on behalf of institutions of higher education..

F. ***Telecommunication Audits***

Pursuant to Massachusetts General Law Chapter 29, Section 29E, authorized contractors were engaged on a contingent fee basis to provide telecommunication services audits to eligible entities of the Commonwealth. In fiscal year 2003, the PMT added five new contractors to this statewide contract to identify current or past billing overcharges and/or improper tariff rates and to negotiate a refund for overcharges with telecommunication companies on behalf of the Commonwealth agencies. Telecommunication services audit could include but are not limited to voice and data communication service recovery. The contract has exercise the first of two (1) year renewal options. There have been five authorized task orders from three different contractors to perform these services. Currently, they are still in the process of completing the audits and therefore have not realized any refunds for the Commonwealth. No payments have been made to the contractors.